STATE OF ILLINOIS
ILLINOIS COMMERCE COMMISSION

ILLINOIS-AMERICAN WATER COMPANY	)	
	)	Docket No. 11-0767
Proposed general increase in water and sewer rates.	)	

BRIEF ON EXCEPTIONS OF ILLINOIS-AMERICAN WATER COMPANY

Albert D. Sturtevant
Anne M. Zehr
Rebecca L. Segal
WHITT STURTEVANT LLP
180 N. LaSalle Street, Suite 2001
Chicago, Illinois 60601
Phone: 312-251-3017
sturtevant@whitt-sturtevant.com
zehr@whitt-sturtevant.com
segal@whitt-sturtevant.com

Mark A. Whitt
WHITT STURTEVANT LLP
PNC Plaza, Suite 2020
155 East Broad Street
Columbus, Ohio 43215
Phone: 614-224-3911
whitt@whitt-sturtevant.com

John J. Reichart
Kenneth C. Jones
Illinois-American Water Company
727 Craig Road
St. Louis, Missouri 63141
314-996-2287
John.Reichart@amwater.com
Kenneth.Jones@amwater.com

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ORAL ARGUMENT REQUESTED

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Illinois-American Water Company ("IAWC" or "Company") hereby submits its Brief on Exceptions to the July 31, 2012 Proposed Order issued by the Administrative Law Judge ("ALJPO" or "Proposed Order"). Each of IAWC's exceptions to the ALJPO are numbered and discussed below. Pursuant to Rule 200.830 of the Commission's Rules of Practice, with respect to each matter discussed, appropriate replacement language for the ALJPO is set forth in the corresponding section of the attached Appendix A – Exceptions ("Appendix A"), which shows the changes from the ALJPO in redline format. 83 Ill. Adm. Code § 200.830(b).

I. POSITION SUMMARY

This Brief on Exceptions does not take issue with every decision in the ALJPO IAWC believes should have been decided differently. There are certain conclusions, however, IAWC cannot accept. Those conclusions relate to issues of vital importance to IAWC because they involve not only substantial impact to IAWC's revenue requirement, but also important policy considerations.

In particular, IAWC takes strong exception to the ALJPO's recommendation of a virtually unprecedented—in Illinois and elsewhere—low return on equity ("ROE") of 9.34%. If adopted, that ROE would represent the lowest authorized return on equity for an Illinois water utility in nearly *forty* years. Indeed, it is *104* basis points lower than the ROE authorized by the Commission in IAWC's last rate case, Docket 09-0319. But there is no record basis to justify a historically low ROE here. As explained below, the ALJPO's 9.34% ROE must be rejected because it:

- Disregards, in its entirety, the testimony of the Company's ROE witness;
- Gives undue weight to analytical results applied to non-water utilities; and
- Fails to consider whether the recommended ROE affords IAWC the opportunity to earn a return commensurate with returns on investments in other enterprises bearing

similar risk.

As also explained more fully below, there are several ways to revise the ALJPO to arrive at a more reasonable ROE, including simply leaving it at its current authorized level of 10.38%, which the record supports. Another is to recognize, of the several analytical approaches used to quantify investor expectations, no one method is any more correct than another and, in fact, strict adherence to one method can lead to flawed conclusions. Based on that recognition, and including the evidence of IAWC's expert, a minimum ROE of 9.84% is warranted. Considering the results of all of the ROE analyses presented by the experts in this case, a simple averaging results in an ROE of 9.99%. IAWC submits that ROE is not only supported by the record, but also more reasonable that the ALJPO's unprecedented 9.34%. In any event, the record supports an ROE in the range of 9.84 – 10.38%, and the Commission should authorize a return in that range.

In addition to the ALJPO's extraordinary ROE, IAWC cannot accept its conclusions regarding Capital Structure, Test Year Sales Volumes and Revenues, Chemical Expense, ADIT – Repairs Deduction – FIN 48, and Costs Related to Audit of Service Company Fees. IAWC takes the following positions with respect to each of these issues:

- *Capital Structure.* The ALJPO adopts a capital structure (comprised of 1.30% short-term debt, 50.60% long-term debt and 48.10% common equity) which no party proposed and, in so doing, rejects IAWC's proposed capital structure, the reasonableness of which no party disputed. There is neither record nor legal support for the ALJPO to impute a hypothetical capital structure. IAWC's forecasted test year capital structure (comprised of 0.26% short-term debt, 49.23% long-term debt and 50.51% common equity) should be adopted instead.

- *Test Year Sales Volumes and Revenues.* The ALJPO aptly recognizes water usage has declined and will continue to decline on a per customer basis. Therefore, it correctly adopts IAWC's forecast of consumption, but only through the year ending September 30, 2012. While the record certainly supports usage decline and thus IAWC's forecast consumption, it supports such a decline through at least the test year. Because the ALJPO stops short, effectively recognizing usage decline only through the next 45 days, it should be revised. Indeed, even recognizing declining usage through the test period, as IAWC's test year sales forecast does, does not fully reflect the impact of declining usage, given that the rates set in this proceeding are expected to be in effect over several years.

- *Chemical Expense*. The ALJPO accepts IIWC/FEA's elementary, one-dimensional method of projecting test year chemical expense, which is based on simple math applied to just one year (2010) of historical usage, over IAWC's detailed chemical calculation model, which was reviewed, and not opposed by, Staff. As it did in IAWC's last rate case, the Commission should reject such a simplistic methodology for calculating production expense. The ALJPO should be revised accordingly.

- *ADIT – FIN 48*. The ALJPO includes in IAWC's test year balance of ADIT (and thus removes from rate base) the balance of the Company's FIN 48 liabilities. That finding must be rejected because it ignores two key record facts: (1) taking uncertain tax positions benefits Illinois ratepayers, and so the ratemaking treatment of FIN 48 amounts should give IAWC the incentive to take such uncertain positions, and (2) FIN 48 amounts are not "cost free" sources of capital; they are subject to interest and penalties. As it stands, the ALJPO's position on FIN 48 not only discourages IAWC (and other utilities) from adopting uncertain tax positions, but also *penalizes* the Company for adopting them. It should be rejected.

- *Management Audit Costs*. The ALJPO correctly recognizes, perhaps in light of the plain language of Section 8-102 of the Public Utilities Act and the Commission's decisions addressing it, that IAWC is entitled to recover the costs it incurrs related to the management audit in Docket 10-0366 other than solely the fee of the independent auditor. But without basis in Illinois law or the record, the ALJPO caps the level of IAWC's incremental audit costs—which no party disputed as unreasonable—at the level of the independent auditor's fee. Because such a cap is unsupported and theoretically unsound, it should be rejected. IAWC should be permitted to recover its full amount of incremental audit costs, consistent with Illinois authority and the record evidence here.

IAWC also takes exception to the ALJPO's language regarding the tariff under which Scott Air Force Base receives service and Air Products' request to consolidate the volumetric charges for its two meters. IAWC does not dispute the ALJPO's ultimate determination on these issues, but rather proposes clarifying language.

II. EXCEPTIONS

A. Exception 1: ALJPO Section VII.C, "Cost of Common Equity", Subsection 4, "Conclusions" (ALJPO, pp. 103-09.)

In discussing the considerations to be borne in mind when determining utility returns on equity, the Commission recently highlighted the need to avoid unreasonably low authorized returns:

> The financial markets' focus on the quality and direction of regulation has sharpened following the 2008 credit crisis. Thus, state commissions play a critical and relevant role in defining the market for utility capital, and we understand that this Commission's decisions play a larger role in setting the Utilities' actual capital costs. The bottom line impact of setting a rate of return too low, unless warranted, could have a deleterious affect on a utility's ability to deliver quality service as well as higher credit costs that will make their way to each ratepayers bill.

Peoples Gas Light & Coke Co./North Shore Gas Co., Order, Docket 11-0280/0282 (cons.) (Jan. 10, 2012), p. 137 (citations omitted).

The ALJPO recommends an ROE of 9.34%. If adopted, this ROE would represent the lowest authorized return on equity for an Illinois water utility since at least 1975. ("At least," because 1975 is as far back as the Commission tracks water ROEs.)[1] An ROE this low would force investors to confront the stark reality that capital investment is less welcome in Illinois than it is elsewhere. Given that recent returns for IAWC's affiliates in other jurisdictions have averaged 10.13%, it is not readily apparent what other conclusion could be drawn—especially since the 9.34% recommendation is lower than what the Commission's own Staff recommends.

The Company recognizes that rate case orders addressing ROE do not typically stray far from an ALJ's recommendation. There have been exceptions, however; a recent one is Docket 11-0280/0282 (cons.), Peoples Gas Light & Coke Co./North Shore Gas Co.'s recent rate increase

[1] See Illinois Commerce Commission, Financial Analysis Division, Rate Case History Report, (Mar. 2012), http://www.icc.illinois.gov/reports.

proceeding, where the ALJ recommended an ROE of 8.85%, but the final order authorized 9.55% (before a 10 basis point reduction related to an uncollectibles rider). The Commission authorized the greater return because the ALJ's recommendation largely disregarded the utility's evidence, resulting in a recommended return well below historical authorized returns. It is for these same reasons that IAWC takes exception to the ROE recommended here. More specifically, the ALJPO:

- Disregards, in its entirety, the testimony of the Company's ROE witness;
- Gives undue weight to analytical results applied to non-water utilities; and
- Fails to consider whether the recommended ROE affords IAWC the opportunity to earn a return commensurate with returns on investments in other enterprises bearing similar risk.

There are several ways to revise the ALJPO to arrive at a more reasonable rate of return. One is to simply leave ROE at its current authorized level of 10.38%, which is well within the range of recommendations presented in this case. Another is to modify the inputs that the ALJPO uses to average various results in arriving at the recommended return. For example, excluding the non-water proxy group results and including IAWC witness Ms. Ahern's CAPM results would produce a return of 9.84%. A simple average of all three experts' final results would produce an ROE of 9.99%. Such returns would still be well below average returns authorized for IAWC affiliates and other utilities in Illinois, but would alleviate the need for the Commission to justify (or for IAWC to explain to investors) why a historically low ROE is warranted in this proceeding.

1. There Is Record Support for Leaving ROE at the Current Authorized Level of 10.38%.

The Company's ROE witness, Pauline Ahern, gave testimony and evidence supporting an ROE of 11.25%. Averaging this result with Staff and IIWC/FEA's recommendations of 9.42%

and 9.3%, respectively, results in an indicated ROE of 9.99%. Because the three recommendations vary from the currently authorized ROE by roughly the same order of magnitude, IAWC's Initial and Reply Briefs suggest that the Commission leave ROE where it is currently. The ALJPO rejects this recommendation:

> The Commission observes that while some factors or variables in the ratemaking process tend to be stable over time, the cost of common equity is not. A number of factors, some specific to a utility others more generally applicable in the economy, vary over time and cause the cost of common equity to vary over time. The Commission is required to evaluate the evidence in the record and while previous Commission decisions may be useful in some instances, the Commission declines to adopt the suggestion in IAWC's brief.

(ALJPO, p. 109.)

No party disputes that various factors cause the cost of common equity to vary over time. The same experts that presented ROE testimony in this proceeding also testified in IAWC's last rate proceeding, and none of their recommendations are the same in this case as they were in the last case. IAWC's suggestion to leave ROE as-is was offered not as an invitation to ignore the record evidence in this proceeding, but as a possible avenue of compromise among the experts' competing recommendations. To the extent the record supports an ROE of 11.25%—and IAWC believes that it does—the record also supports continuation of the previously authorized return of 10.38%. IIWC/FEA concede that "Illinois-American's cost of common equity is *no higher* today than it was in its last case . . . ." (IIWC/FEA Ex. 1.0 (Gorman Dir.), p. 4, lines 62-63 (emphasis added).)

This Commission would not render IAWC an outlier if it decided to leave ROE where it is. Late in 2011, the Pennsylvania commission allowed a return on equity for Pennsylvania American Water of 10.25%. Tennessee American put rates into effect in April 2011 reflecting a 10% return; new rates reflecting the same return were authorized in April 2012. Likewise, Missouri American rates reflected a 10% return as of July 2010, and in February 2012 the Public

Service Commission in that state approved a settlement that also includes a 10% equity return.[2]

While it is true that some states have reduced equity returns in recent years, none have come close to the drastic, 104 basis point reduction proposed here. New Jersey American's authorized return was reduced from 10.30% in January 2011 to 10.15% in May 2012. Indiana dropped from 10% in May 2010 to 9.7% in June 2012. Indiana and West Virginia are currently the only two American Water utilities with authorized returns of less than 10%, at 9.7% and 9.75%, respectively. Between April 2010 and February 2012, the average authorized return on equity for regulated affiliates of IAWC was 10.13%. (See IIWC/FEA Ex. 1.0, p. 7.)

It goes without saying that this Commission is not bound by decisions of other jurisdictions, or even its own decisions, for that matter. Commonwealth Edison Co. v. Ill. Commerce Comm'n, 405 Ill. App. 3d 389, 407 (2nd Dist. 2010); Peoples Gas Light & Coke Co./ North Shore Gas Co., Order, Docket 07-0241 (Feb. 5, 2008), p. 152. But answering whether a proposed ROE is "just and reasonable" begs the question: reasonable compared to what? Historical ROEs provide a reference point for answering this question. And regardless of the extent to which the Commission could or should base its decisions on its own prior orders or those of neighboring jurisdictions, there can be no doubt that regulatory orders greatly influence investors. "We are cognizant that the Commission's ratemaking decisions are increasingly important to the Utilities' ability to maintain investment grade credit ratings and reasonable capital costs. Indeed, the quality and direction of regulation, in particular the ability to recover costs and earn a reasonable return, are among the most important considerations when a credit rating agency assesses utility credit quality and assigns credit ratings." Peoples Gas Light &

[2] These ROEs are based on IIWC/FEA Ex. 1.0, Table 2 and the following cases: Tennessee American Water Co., Order, Docket 10-00189, 2012 Tenn. PUC LEXIS 76, *267 (Tenn. Reg. Auth. Apr. 27, 2012); Missouri-American Water Co., Order, Docket WR-2011-0337, 2012 Mo. PSC LEXIS 248 (Mo. PSC Mar. 7, 2012) (approving Feb. 24, 2012 settlement); Missouri American Water Co., Order, Docket WR-2010-0131, 2010 Mo. PSC Lexis 595 (Mo. PSC Jun. 16, 2010) (approving May 24, 2010 settlement).

Coke Co./North Shore Gas Co., Order, Docket 11-0280/0282 (cons.) (Jan. 10, 2012), p. 137.

The returns authorized in Dockets 09-0319 (10.38%) and 07-0507 (10.35%) have been supportive of IAWC's investment of approximately $400 million over the last five years. A 9.34% return, however, may not promote this level of investment going forward.

2. The ALJPO Disregards the Company's Evidence.

The ALJPO does a very good job of summarizing each party's evidence and arguments. The problem is that a great deal of what is summarized, at least with respect to the Company, is not taken into account in the ultimate recommendation.

Experts generally estimate a utility's ROE using one or more analytical techniques that rely on market-based data to quantify investor expectations. The use of more than one approach allows for the selection of an authorized ROE based on a range of quantitative results as well as other relevant qualitative information. Strict adherence to a single approach—and likewise strict adherence to the assumptions and inputs underlying that approach—can lead to flawed conclusions. No one method is any more "correct" than any other method in all circumstances. See Peoples Gas Light & Coke Co./North Shore Gas Co., Order, Docket 09-0166/0167 (cons.) (Jan. 21, 2010), p. 123 (finding "there is no model to produce perfectly reliable results"). Nor does the process necessarily lend itself to a strict mathematical solution. Id., p. 124 ("Each case must be decided on its own merits."). The key consideration is that the methodologies and information relied on reasonably reflect investors' views of the financial markets and the subject utility.

Among the analytical models employed in this proceeding, each of the three witnesses performed constant growth DCF and CAPM analyses. Staff and IIWC/FEA also performed multi-stage DCF analyses. The ALJPO arrives at a recommended ROE by averaging (a) Staff and IIWC/FEA's multistage DCF results, (b) Staff's CAPM results and (c) averaging these two averages. (See ALJPO, p. 108.) It is understandable that the ALJPO did not give weight to IIWC/FEA's CAPM results because their own witness, Mr. Gorman, essentially disregarded them. (IIWC/FEA Ex. 1.0, p. 36.) But no explanation is provided for excluding the Company's CAPM results, and no rationale can be imputed from the record. Ms. Ahern's water proxy group CAPM of 10.77% is not far afield of Staff's observation of 10.44%. The arbitrary exclusion of Ms. Ahern's CAPM results understates a reasonable ROE.

The ALJPO also should not have ignored Ms. Ahern's constant growth DCF results. Indeed, in Aqua Illinois, Inc.'s ("Aqua") most recent rate case, *Staff based its recommendation on a constant growth DCF.* See Aqua Ill., Inc., Order, Docket 11-0436 (Feb. 16, 2012), p. 35. There the Commission concluded, "it would be reasonable to rely on either the constant or non-constant DCF analyses performed by Staff." (Id., p. 36.) The Commission found no "fundamental problems with the [constant growth DCF] model," contrary to the ALJPO's suggestion (p.108), nor does the ALJPO identify errors or mistakes in the "inputs" to Ms. Ahern's model (id.). It was arbitrary and unreasonable to disregard not only IAWC's constant growth DCF (indicating a 9.96% return), but also the constant growth results of IIWC/FEA (10.18%) and Staff (18.65%).

3. The ROE Recommendation Should Not Consider Non-Water Proxy Group Results.

The averaging approach used in the ALJPO recommendation includes the constant growth DCF and CAPM results for Staff and IIWC/FEA's non-water utility proxy groups. The non-water proxy group results should not have been considered because no demonstration has been made that the companies included in the non-water proxy group bear financial risk comparable to IAWC. As shown on page 108 of the ALJPO, including the results for non-water companies dramatically reduces IAWC's indicated ROE.

Staff and IIWC/FEA go through numerous machinations to try to show that water companies bear the same or similar financial risks as gas or other non-water utilities. If this were true, one would expect to see a correlation between relative levels of risk among water and non-water utilities, as indicated by ROE analyses performed for similar companies during comparable time periods. The available data shows anything but. In Docket 11-0436 (cited in the ALJPO as *justification* for considering a non-water proxy group), Staff developed both water and non-water proxy groups to estimate Aqua's ROE. Staff's constant growth DCF results were 8.36% for its water sample and 9.65% for its utility sample. Aqua Ill., Inc., Order, Docket 11-0436, pp. 19-20. Its CAPM results were 9.81% for the water sample and 10.58% for the utility sample. Id., p. 20. Staff's recommendation, which the Commission adopted, gave 2/3 weight to the water sample results and 1/3 weight to the non-water results, in large part because "Aqua is closer in risk to the Water Sample than the Utility Sample." Id., p. 22.

In this proceeding, the situation is the reverse: Staff and IIWC/FEA's DCF and CAPM results are uniformly *higher* for their water samples than for their utility samples. (See ALJPO, p. 108.) And no suggestion has been made that the higher water sample results should be given 2/3 weight, as they were in the Aqua proceeding, when the water samples produced lower indicated returns than the non-water samples.

Whether the pool of companies with risk comparable to IAWC is large or small seems largely beside the point: it is what it is. The ALJPO seems to suggest that it is appropriate to look beyond the water industry to construct a hypothetical group of firms that do not exist; firms that bear an aggregate financial risk somewhere between that of a water company and a gas company. "Given the relatively small number of firms that make up the water industry, it is *plausible* that a sample from the gas or electric industry might be more similar to a *target* water utility than a sample from the water industry." (ALJPO, pp. 103-04 (emphasis added).) But the question of what is "plausible" for a hypothetical "target water utility" is not a question for this case. The question for this case is what is appropriate for IAWC. The unrebutted evidence shows that water utilities are far more capital intensive than other utilities, and thus bear greater financial risk. (IAWC Init. Br., p. 87.) Using a proxy group comprised of non-water utilities for an ROE analysis for a water company cannot reflect specific water industry risk, and is therefore inadequate for water utility cost of capital purposes. (Id.)

4. The Recommended ROE Is Not Comparable to Returns Authorized for Similar Utilities Facing Similar Risk.

The recommended ROE of 9.34% is virtually unprecedented—in Illinois or anywhere else.

As a matter of federal Constitutional law, IAWC is lawfully entitled to an opportunity to earn a reasonable rate of return comparable to other industries bearing similar risk. "The return to the equity owner should be commensurate with returns on investments in other enterprises having corresponding risks. That return, moreover, should be sufficient to assure confidence in the financial integrity of the enterprise, so as to maintain its credit and attract capital." Federal Power Comm'n v. Hope Natural Gas Co., 320 U.S. 591, 603 (1944).

An equity return of 9.34% is not comparable to returns authorized for other Illinois utilities. In the nearly 40-year period since the Commission started keeping track of authorized ROEs, rarely has a water utility been authorized to earn less than 10%. The ALJPO concludes that IAWC faces risks comparable to Illinois gas utilities, but since 1972, only two gas utilities received an ROE lower than what is being recommended here. (AmerenCILCO received a 9.19% in Docket 09-0306, etc. (cons.); Ameren Illinois Co., a 9.22% in Docket 11-0282.) In only one case in the past 43 years has an electric utility received an ROE of less than 10%.[3]

As discussed above, 9.34% is also nowhere near the equity returns authorized to IAWC's affiliates in neighboring jurisdictions. And although the Company has not performed a comprehensive analysis of authorized ROEs across all industries and states in reviewing historical returns authorized in Illinois, it quickly becomes apparent that the lowest returns have been meted out only recently. The lowest authorized gas and electric returns (9.19% and 9.9%, respectively) were handed down to AmerenCIPS and AmerenCILCO in Docket 09-0306, etc. (cons.). The lowest water utility return, 9.49%, was authorized for Aqua in Docket 11-0436. Some would say that this should be expected; U.S. Treasury yields are at record lows, so money must be bountiful and cheap. The problem with this logic is that it does not examine *why* Treasury yields are so low. As the evidence in this case demonstrated, volatility in the U.S. and international equity markets has steadily *increased*, causing a "flight to quality" from equity securities to U.S. Treasury bonds, which has put downward pressure on Treasury yields. Equity investors require *greater* compensation to invest in equity securities, not less. (IAWC Init. Br., pp. 80-81.) The fact that public utilities can currently issue *debt* at historically low rates does not diminish their investor-required cost of *equity*—at least not to the level proposed here.

As IAWC explained in its Initial Brief (pp. 1-3), IAWC's water and wastewater operations are subject to federal, state and local laws and regulations, which control environmental protection, health and safety, water quality, water allocation rights, and collection, treatment and discharge of wastewater through monitoring and reporting requirements. Substantial investment is needed to meet these requirements, as well as to replace aging infrastructure and modernize its systems, and IAWC has accordingly invested almost $400

[3] See Illinois Commerce Commission, Financial Analysis Division, Rate Case History Report, (Mar. 2012), http://www.icc.illinois.gov/reports.

million in the last five years. Such investment was supported by authorized ROEs of 10.35% and then 10.38%. But if the Commission chooses to continue to lower the bar on authorized equity returns, the State of Illinois will eventually get less investment, fewer jobs, and service diminished to bare-minimum regulatory levels.

Some would dismiss this warning as typical utility "doom and gloom." But the Commission itself has recognized that setting ROE too low is bad for utilities, bad for investors and bad for customers. "If the Commission set the authorized ROR below a utility's actual cost of capital, the financial strength of the utility could deteriorate, making it difficult for the utility to raise capital at reasonable cost. Ultimately, the utility's inability to raise sufficient capital would impair service quality." Aqua Ill., Inc., Order, Docket 11-0436, p. 136 (quoting Staff testimony). Thus, the ROE authorized in this proceeding will be among the "key considerations in investors' decisions about whether to invest in utilities as opposed to other industries." Id. "Utility investors understand and accept the role of pervasive regulation, but they seek from the regulatory process decision-making that is fair, with a significant degree of predictability." Id. (quotation omitted). Continuing a trend of ever-decreasing ROEs is not the type of "predictability" investors expect.

5. The Record Supports a ROE in the Range of 9.84 – 10.38%.

Two adjustments would go a long way in fashioning a ROE that is more reasonable (or less unreasonable, as the case may be) than what has been recommended.

The first would be to exclude DCF and CAPM results for non-water utilities.[4] The second would be to include Ms. Ahern's CAPM results of 10.77%.[5] Making one of these

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[4] This change alone would result in a ROE of 9.76%: [(9.19 + 8.95)/2 + 10.44]/2 = 9.76

[5] This adjustment, by itself, would result in a ROE of 9.49%: (9.22 + 10.44 + 10.77)/3 = 10.14; (10.14 + 8.84)/2 = 9.49

adjustments or the other, however, will not produce a rate of return sufficient to support IAWC's investment requirements. Both adjustments are necessary. Including Ms. Ahern's CAPM results and excluding the non-water results produces an indicated return of 9.84%.[6] This is the *bare minimum*, borderline-confiscatory return indicated by the record in this proceeding, and establishes a floor for the minimum ROE.

As the Commission has previously recognized, however, authorizing returns that are borderline confiscatory is not in the best interests of ratepayers or utilities. Something above the bare-minimum is necessary. The Commission could consider 10.38% (IAWC's currently-authorized ROE) as the ceiling, and authorize an ROE somewhere between 9.84% and 10.38%. The mid-point of this range is 10.11%, which happens to be very close to average returns authorized for IAWC affiliates. Alternatively, as noted above, a 9.99% return is indicated by a simple average of the results presented by each of the three experts, and also fits in the 9.84 - 10.38% range. The Final Order should authorize a return in the range of 9.84 -10.38%.

The Commission should adopt the exceptions language included in Appendix A.

B. Exception 2: ALJPO Section VII.B, "Capital Structure", Subsection 3, "Conclusions" (ALJPO, pp. 75-77.)

The recommended capital structure is comprised of 1.30% short-term debt, 50.60% long-term debt and 48.10% common equity. (ALJPO, p. 77.) No party argued for or otherwise submitted evidence supporting this capital structure. IAWC therefore takes exception to this recommendation and submits that the appropriate capital structure in this case, based on the record, is IAWC's forecasted capital structure.

It is important to keep in mind that *no party disputed IAWC's forecasted capital structure.* That capital structure was developed from IAWC's business plan, and no party

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[6] (9.19 + 8.95)/2 + (10.44 + 10.77)/2 = 9.84

challenged the business plan assumptions, either. Staff's argument is that the forecasted capital structure cannot be used, based on a misguided theory that to do so would somehow increase risk to IAWC (when in fact the opposite is true). Staff *did not* argue that the forecast was unreasonable or inaccurate.

The ALJPO determines an imputed capital structure based on a proportional calculation using IAWC's prior capital structure as a starting point. But "imputing a hypothetical capital structure for ratemaking purposes to determine a utility's rates is a serious adjustment, and should only be adopted when a utility's actual capital structure is found to be unreasonable, imprudent, or unduly affected by such circumstances as double leverage so as to unfairly burden the utility's customers." Illinois Commerce Comm'n v. Eldorado Water Co., Order, Docket 93-0219, 1994 Ill. PUC LEXIS 278, *64 (Jan. 20, 1988); see also Illinois Power Co. v. Ill. Commerce Comm'n, Order, Docket 89-0276, 1990 Ill. PUC LEXIS 313, *332 (June 6, 1990).

Instead, IAWC's forecasted capital structure should be used. IAWC's forecasted average capital structure for the test year ending September 30, 2013 is comprised of 0.26% short-term debt, 49.23% long-term debt and 50.51% common equity. IAWC explained at length in its direct case why its proposed test year capital structure was reasonable. (IAWC Ex. 6.00 (Rev.) (Rungren Dir.), pp. 15-20.) IIWC/FEA do not dispute that this capital structure is reasonable. (IIWC/FEA Ex. 1.0 (Gorman Dir.), p. 15, lines 266-67 ("The water utility proxy group's common equity ratio is comparable to Illinois-American's proposed common equity ratio of 50.8%.").)

The Company and Staff litigated at some length over whose proposed capital structure complied with or violated Section 9-230 of the Illinois Public Utilities Act, 220 ILCS 5/9-230. The ALJPO does not address these arguments directly, but characterizes them as "informative" or "of interest." (ALJPO p. 76.) Instead, much of the ALJPO's conclusion centers around curiosity as to why the Company and Staff agreed on capital structure in Docket 09-0319 but not in this proceeding. "The Commission finds it curious that there is such a significant disagreement in this proceeding over an issue on which the same parties were in agreement in the previous case." (Id., p. 76.) Nevertheless, the ALJPO correctly declines to adopt Staff's imputed capital structure. As discussed in briefing, Staff's highly-leveraged capital structure (1.30% short-term debt, 56.70% long-term debt and 42.00% common equity) would impute greater financial risk to IAWC, not less, and is forbidden under Section 9-230.[7] (Id., p. 75.) It is notable that in Docket 11-0436, Staff did not pursue this argument, and in fact agreed with Aqua's forecasted capital structure containing 53.31% common equity. Aqua Ill., Inc., Order, Docket 11-0436 (Feb. 16, 2012), p. 11. Moreover, as explained in IAWC's Initial Brief (pp. 73-74), the Commission recognized in Docket 06-0336 that American Water and IAWC could have divergent equity ratios, and that IAWC's could be higher.

The implication of adopting a capital structure not proposed by any party is that the recommended capital structure has no record support. The apparent reason for rejecting the parties' evidence is the belief that no party "provided a compelling explanation why its proposal in this proceeding varies so far from what it proposed in Docket No. 09-0319 . . . . [T]he record is devoid of any persuasive reason the capital structure approved in this proceeding should vary significantly from the one approved in Docket No. 09-0319." (ALJPO, p. 76.) But as noted just two sentences earlier, in the same paragraph, the ALJPO acknowledges that "neither IAWC nor the Staff has any obligation to begin with or compare its proposed capital structure to what it proposed or what was adopted in the previous rate case." (Id.) Not addressing an issue that a

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[7] This may explain why, during briefing, Staff modified its recommendation to change the long-term debt and common equity balances to 50.23% and 48.44%, respectively.

party is not required to address is not a basis to disregard that party's evidence.[8]

IAWC's exceptions language in Appendix A incorporates the Company's forecasted capital structure and should be adopted.

C. Exception 3: ALJPO Section V.A, "Test Year Sales Volumes and Revenues", Subsection 3, "IAWC Position" (ALJPO, pp. 42-43) and Subsection 4, "Commission Conclusions" (ALJPO, pp. 45-47.)

The ALJPO correctly finds that IAWC is experiencing declining usage. The ALJPO also correctly rejects IIWC/FEA's recommendation for test year sales because it ignores that decline, and approves IAWC's residential sales forecast through September 30, 2012. However, the ALJPO stops short, cutting off that forecast at September 30, 2012, and not continuing it through the end of IAWC's test year. The ALJPO should be revised to adopt IAWC's forecast of residential usage through the test year.

In adjusting IAWC's test year revenue forecast to reflect the residential sales forecast for the year ending September 30, 2012, the ALJPO acknowledges "the record supports IAWC's assertion that residential sales volume, on a per customer basis, has been declining and can reasonably be expect[ed] to continue to decline *in the short term*."[9] (ALJPO, p. 45 (emphasis added).) The ALJPO, however, limits "the short term" to the immediate future (approximately the next 45 days) by adopting the projected consumption for the year ending September 30, 2012 as the test year usage level. (Id., pp. 46-47.) The "short term," however, is more reasonably viewed as continuing at least through IAWC's test year ending September 30, 2013. As IAWC

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[8] The ALJPO eventually addresses its own criticism in the ROE section. In rejecting the Company's proposal to maintain ROE at the currently authorized level of 10.38%, the ALJPO states: "while some factors or variables in the ratemaking process tend to be stable over time, the cost of common equity is not. A number of factors, some specific to a utility others more generally applicable in the economy, vary over time and cause the cost of common equity to vary over time." (ALJPO, p. 109.) Given the linkage between ROE and the capital structure to which it is applied in arriving at an overall rate of return, the factors that affect capital structure also are variable.

[9] For this reason—the expectation of declining usage—the ALJPO correctly rejects IIWC/FEA's test year consumption forecast because it relies on historical usage. (ALJPO, p. 46.)

explained in testimony, the decline in usage has been driven by visible, explainable drivers over the last several years, and these drivers continue to be in place and will influence water usage over the next several years. Thus, IAWC anticipates it will continue to experience declining usage for years to come. (IAWC Ex. 8.00R (Rev.) (Naumick Reb.), pp. 11-14.) Given the reality of declining usage, the record supports utilizing IAWC's test year forecast of residential sales. In fact, this is conservative: even recognizing declining usage through the test period, as IAWC's test year sales forecast does, does not fully reflect the impact of declining usage, given that the rates set in this proceeding are expected to be in effect over several years. (See IAWC Ex. 14.00SR (Rev.) (Heid Sur.), p. 5 (noting even a 1% annual decline in usage equates to a 3% decline over the two to three-year period over which rates are expected to be in effect).)

The basis for the ALJPO's limitation of the projection of declining usage to September 30, 2012 is concern about certain aspects of IAWC's forecast methodology.[10] Yet the record regarding IAWC's forecast methodology does not warrant imposing a cutoff on IAWC's test year forecast of residential sales. As the record reflects, IAWC explained in detail in testimony and briefing its usage forecast model, covering residential, commercial and other public authority usage, and how the model functioned. (IAWC Exs. 5.00 (Rev.) (Kerckhove Dir.), pp. 9-10; 5.00SUPP (Kerckhove Supp. Dir.), pp. 13-14; IAWC Init. Br., pp. 47-48.) IAWC also explained why its forecast was reliable and AG witness Mr. Rubin's criticisms of that model were not warranted. (IAWC Exs. 8.00R (Rev.), pp. 1-18; 8.00SR (Rev.) (Naumick Sur.).) IAWC pointed out (and the ALJPO acknowledges) that Mr. Rubin ultimately recommended use of a sales forecast (for 2012) derived using IAWC's methodology. Staff does not oppose IAWC's test year

[10] IAWC respectfully notes the ALJPO appears inconsistent here: on one hand raising concern regarding IAWC's method of predicting (a decline in) future sales, while on the other, regarding the RAC, concluding "the record does not indicate why water sales are more difficult to predict than other elements in a forecasted test year." (ALJPO, p. 163.)

sales forecast. (In fact, the Company provided its projection model for residential, commercial and other public authority usage—consisting of no less than 38 separate Excel files, each with multiple worksheets—in response to a Staff data request. IAWC does not object to offering this information into the record in future cases.) Thus, the record shows that IAWC's forecast methodology for residential sales is sufficiently reliable to support IAWC's projected test year level of residential sales and revenue.

The ALJPO's stated concern about IAWC's forecast relates to the question of whether time is a valid proxy for the myriad factors influencing residential usage. (ALJPO, p. 46.) But the record supports the conclusion that it is. As IAWC explained extensively in testimony, it conducted a time series statistical regression analysis because such analysis recognizes that multiple factors are influencing the trend, and that these factors are occurring *over time*. It does not selectively include or exclude specific factors that may be impacting base usage, but instead quantifies the composite effect that all relevant factors are having *over time*. For instance, replacements of water-using appliances with more efficient ones occur *over time*; there is not a massive, one-time replacement. IAWC's linear regression analysis thus appropriately recognizes that factors are continuing to influence customer usage. (IAWC Ex. 8.00R (Rev.), pp. 4-5.)

Notably, IAWC witness Gary A. Naumick, an engineer with nearly 10 years experience with the United States Environmental Protection Agency, over 25 years experience with American Water, and who has studied and presented on the topic of water consumption trends for over eight years, evaluated the results of IAWC's usage forecast methodology. (IAWC Ex. 8.00 (Naumick Dir.), pp. 2-3.) Mr. Naumick found the results consistent with the significant declining usage trend he is seeing in the entire water industry and testified extensively regarding the myriad drivers that have been accepted by the industry as influencing the decline on nonweather sensitive, "base" water consumption: increasingly efficient plumbing fixtures, increasing consumer conservation ethic and government regulation regarding consumption, to name several. (See generally id.) Further, he testified IAWC's forecast results are consistent with not only the presence of those drivers, but also the results of analyses he has conducted regarding base consumption trends for other water utilities and, more telling, the trend currently experienced by the entire water industry. (IAWC Exs. 8.00R (Rev.), pp. 13-15; 8.00SR (Rev.), p 5.) In fact, he pointed to an American Water Works Association article in which water industry representatives agree the industry is experiencing a "new normal" and there will not be a "rebound." (IAWC Ex. 8.00R (Rev.), p. 15.) Put simply, all evidence points toward a continuing decline in residential consumption per customer, and IAWC's forecast confirms as much. The record shows that IAWC's forecast methodology was robust and supported by substantial information, and that Mr. Naumick's extensive experience confirmed the results of the methodology as consistent with industry trends.

The ALJPO likewise is inconsistent when it adopts a sales forecast that is *greater* than IAWC's test year projection, but leaves purchased fuel and power and chemical expenses, which are necessarily dependent on sales volume, at the test year levels. If IAWC's new rates are to be established on its projected usage for the year ending September 30, 2012, then, to be consistent, IAWC's purchased fuel and power and chemical expenses likewise should be set at a corresponding level. Thus, those production expenses should be increased by $182,000. (See AG Ex. 2.2, Sch. C-1, line 2.)

Current and anticipated declining usage is supported by the record and is a reality the ALJPO recognizes. (ALJPO, p. 45.) As a result, IAWC's test year forecast consumption should be approved. (In the alternative, if the Commission approves year ending September 30, 2012 usage as the test year level of usage (it should not), the test year levels of purchased fuel and power expense and chemicals expense should be increased accordingly.) The Commission should adopt IAWC's exceptions language included in Appendix A. Alternative language also is proposed.

D. Exception 4: ALJPO Section V.E, "Chemical Expense" (ALJPO, p. 59.)

The ALJPO accepts IIWC/FEA's downward adjustment to IAWC's projected $7,626,127 test year level of chemical expense, finding, without explanation, that IIWC/FEA's proposed level of expense "provides a better forecast of test year expense." (ALJPO, p. 59.) IAWC respectfully submits that the record demonstrates that it does not. IIWC/FEA's recommendation is based on a simplistic cost per unit calculation that does not, as IAWC's unrebutted evidence shows, account for the myriad factors that impact chemical expense. Rather, IIWC/FEA's approach is based on the unexplained and unproven assumption that there must be a direct linear relationship between the volume of water produced and the amount of a chemical used, and that the unit cost of each chemical remains constant, unaffected by changes in market price. The record makes clear that this is not the case. Thus, as it did in IAWC's last rate case, the Commission should dismiss IIWC/FEA's unsophisticated approach to forecasting, and the ALJPO should be revised accordingly.

IIWC/FEA proposed the adjustment adopted by the ALJPO in direct testimony. (IIWC/FEA Ex. 2.0 (Collins Dir.), pp. 15-17.) IAWC responded to that testimony in rebuttal, explaining why IIWC/FEA's proposed adjustment was not appropriate. IIWC/FEA did not respond to IAWC's rebuttal testimony, either in further testimony or at hearing. As such, IAWC's rebuttal evidence was uncontested and unrebutted, and must therefore be dispositive of the issue. <u>See</u> <u>Thigpen v. Ret. Bd. of Fireman's Annuity & Benefit Fund of Chicago</u>, 317 Ill. App. 3d 1010, 1021 (1st Dist. 2000) ("[T]he agency as fact finder cannot simply disregard the testimony of an unimpeached witness where the testimony is uncontradicted and is not inherently improbable.")

As IAWC witness Mr. Suits explained in his uncontested rebuttal, IAWC's projected level of chemical expense was derived from a chemical calculation model which takes negotiated unit costs for *each* chemical IAWC uses and calculates a chemical cost based on historic dosage amounts over a period of multiple years. (IAWC Ex. 2.00R (2d Rev.) (Suits Reb.), pp. 7, 9.) Specifically, the model factors in anticipated system delivery, projected chemical unit costs (typically established through national procurement competitive bids) for each individual chemical, and historical treatment requirements in calculating total chemical expense. (Id., pp. 7-8.) In addition, it considers the total treated water requirement by combining projected total delivered water and internal plant usage by month. (Id., p. 7.) Inputs are reviewed for possible changes in the water treatment process resulting from new regulations or possible efficiency or technology improvements. (Id.) Additionally, the historical chemical usage inputs are adjusted, if necessary, to reflect changes in treatment requirements. (Id., pp. 7-8.) Monthly chemical costs are developed from the quantity per million gallons per month required to treat the total projected treated water at the established costs per unit. (Id., p. 8.) Given that IAWC's detailed chemical expense projection model takes into consideration historical dosage on a monthly basis over multiple years for each chemical—which appropriately accounts for the many variables that impact (changing) chemical usage and costs—it produces a projected level of chemical expense which is reasonable. (Id., p. 9.) Staff does not dispute this. (In discovery, IAWC provided Staff with its chemical usage model workpapers. Staff has not taken issue with IAWC's projected test year level of chemical expense based on that model.)

IIWC/FEA witness Mr. Collins determined his recommended test year level of chemical expense by dividing the 2010 actual total chemical expense for the Total Company and Zone 1 by the 2010 actual total sales volumes for the Total Company and Zone 1 to arrive at per unit total chemical costs for those areas. (IIWC/FEA Init. Br., pp. 3-4; IIWC/FEA Exs. 2.0, pp. 15-16; 2.2.) On this simple division, IIWC/FEA bases its entire recommendation—that the test year level of chemical expense for the Total Company and Zone 1 be capped at the per unit chemical costs Mr. Collins calculated for 2010. (IIWC/FEA Init. Br., pp. 3, 4-5; IIWC/FEA Ex. 2.0, p. 16.)

In stark contrast to IAWC's detailed projection model, IIWC/FEA's analysis is elementary, is based on only one year (2010) of historical usage and fails to take into account the myriad factors impacting chemical expense. (IAWC Ex. 2.00R (2d Rev.), p. 8.) IIWC/FEA's position instead assumes, without explanation, that a direct relationship exists between the volume of sales and the amount, type and cost of chemicals used. (Id., p. 9.) In refuting these points, IAWC went unrebutted in testimony. (See generally IIWC/FEA Ex. 4.0 (Collins Reb.).)

In particular, IIWC/FEA failed to demonstrate that IAWC's projected test year level of chemical expense is not prudent or necessary to meet projected chemical needs based on projections of usage and chemical cost. Mr. Collins did not testify that IAWC's projected chemical dosage amounts for any individual chemical are not accurate. And he did not testify that IAWC's projected cost for any individual chemicals are inaccurate. (See generally IIWC/FEA Exs. 2.0; 4.0.) Rather, Mr. Collins proposes a mathematical exercise that inflates the perceived increase in IAWC's chemical expense from 2010 to be, as the ALJPO describes, "a per-unit increase of 13% for Zone 1 in the test year chemical expense over the actual level of expense from 2010." (ALJPO, p. 59.) In fact, looking at total chemical expense tells a different story. As the record shows, IAWC's projected test year level of chemical expense is approximately $142,000 less than what the Commission authorized in Docket 09-0319. (IAWC Ex. 2.00 (2d Rev.), p. 7.) Moreover, comparing IAWC's actual 2010 chemical expense as cited by IIWC/FEA of $7,193,393 (IIWC/FEA Ex. 2.0, p.15) with IAWC's projected test year level of chemical expense of $7,626,127 produces a projected increase of $432,734, or only 6%. Over the period from December 31, 2010 to September 30, 2013, this equates to an annual increase of just over 2% per year—a far cry from the 13% increase claimed by IIWC/FEA under its methodology. As such, the Commission should reject IIWC/FEA's recommendation, and the simple division on which it is based.

Moreover, the Commission has previously rejected the type of methodology on which IIWC/FEA's position is based. In Docket 09-0319, IIWC proposed an adjustment to another production-related expense, purchased fuel and power, based on the same one-dimensional cost per unit methodology Mr. Collins employed in this case. Order, Docket 09-0319 (Apr. 13, 2010), p. 49. The Commission discarded that adjustment, stating, "the Commission is not convinced of the merit in IIWC's proposed method for capping or calculating PPF expense." Id., p. 54. The Commission also found problematic Mr. Collins' failure in that case (as in this one) to calculate an adjustment for all of IAWC's rate areas: "it does not appear that IIWC has properly considered the amount of electricity used in each district. In fact, it is not entirely clear how the Commission is expected to implement the IIWC proposal for each district based on a cap of $0.144 per CCF." Id. Likewise, in this case, IIWC/FEA proposed adjustments for the Total Company and Zone 1, but failed to calculate the impact on the remaining districts. Although the ALJPO itself allocates the adjusted expense to the remaining districts (ALJPO, p. 59), IAWC submits this appears to disregard that the cost of chemicals or level of chemical use will not be identical in each district.

Notably, Mr. Collins also initially proposed an adjustment to IAWC's projected level of purchased fuel and power expense in this case. (IIWC/FEA Ex. 2.0, pp. 12-14.) However, IIWC/FEA apparently abandoned that adjustment after IAWC's update filing reflected a $1.768 million reduction in the expense resulting from new contract terms negotiated by the Service Company's Supply Chain on behalf of IAWC. (IAWC Exs. 1.00SUPP (Teasley Supp. Dir.), p. 5; 7.00SUPP (Bernsen Supp. Dir.), pp. 6-7; 2.00R (2d Rev.), p. 5.) Chemical expense and purchased fuel and power are both key elements of production costs. Thus, Mr. Collins' methodology also is flawed because it views chemical expense in strict isolation from any other costs. Considered together, the test year level of those related production expenses decreased significantly—by *over $3 million*—from the Commission-approved levels in Docket 09-0319. See Order, Docket 09-0319, Appx. A, p. 1; (IAWC Ex. 7.02SUPP (Sch. C-2 First Rev).) Although the Commission certainly can consider those related expenses in isolation, IAWC submits that it should consider them together.

In sum, Mr. Collins' simple division is no substitute for IAWC's detailed chemical expense projection model and has been dismissed by the Commission before. IIWC/FEA's adjustment based solely on that simple methodology should not have been adopted by the ALJPO. The ALJPO should be revised accordingly and the Commission should adopt IAWC's exceptions language included in Appendix A.

In addition, the ALJPO does not contain a summary of IAWC's position on this issue.[11] IAWC proposes that the ALJPO be revised to adopt a statement of IAWC's position as shown in Appendix A.

[11] The ALJPO correctly notes that IAWC did not submit briefing on this issue. The omission was inadvertent.

E. Exception 5: ALJPO Section IV.D, "ADIT – Repairs Deduction – FIN 48", Subsection 4, "Conclusion" (ALJPO, pp. 35-36.)

The ALJPO's conclusion on the FIN 48 issue is flawed for three reasons:

- The ALJPO accounts for the result of the *less likely* scenario (that the taxing authority will accept the uncertain tax position and the FIN 48 amounts will not have to be remitted to that authority), but fails to protect the utility from *the more likely* scenario (that IAWC will have to remit the FIN 48 amounts to the taxing authority with interest and / or penalties).

- The ALJPO eliminates the incentive to take uncertain tax positions, despite the fact that the record establishes that taking uncertain tax positions can ultimately benefit ratepayers.

- The ALJPO incorrectly concludes (p. 35) "that the FIN 48 amount represents a source of cost-free capital," when the record makes clear that there is a cost associated with the FIN 48 amounts.

Thus, the ALJPO should be revised to remove the FIN 48 balances from ADIT and so provide IAWC with the incentive to pursue the uncertain tax position which, if successful, will result in a ratepayer benefit (through higher tax deductions, which produce lower current tax expense and an increased deferred tax amount, which would be deducted from rate base as ADIT).

The ALJPO concludes that "IAWC's proposal does not contain a mechanism to protect customers while awaiting an IRS review. Therefore, if the IRS does not disallow the tax deduction associated with the FIN 48 reserve, customers would not receive the benefit of the deferred tax credits, in the form of a rate base reduction, until the first rate case after tax returns are no longer subject to IRS review and adjustment." (ALJPO, p. 35.) In so finding, the ALJPO addresses a scenario that is the *less likely* scenario to occur—the scenario where the "IRS does not disallow the tax deduction associated with the FIN 48 reserve." However, the AJLPO ignores the scenario that *more likely than not* will occur—that the IRS disallows the proposed tax deduction and IAWC has to repay the FIN 48 amounts to the taxing authority. Under that *more* *likely* scenario, if the ALJPO's determination was adopted, IAWC will be subject to a rate base deduction for amounts that it more likely than not will have to remit to the taxing authority. As a result, IAWC could be faced with a situation where its rate base has been reduced for funds that it no longer has.

As IAWC explained in its Initial Brief (p. 37), FIN 48 instructs public companies to account for the consequences of tax positions taken by the taxpayer that are likely to be disputed and ultimately disallowed by the taxing authorities. (IAWC Ex. 13.00R (Warren Reb.), p. 9.) The amount of tax that IAWC and its outside auditors have concluded "more likely than not" will eventually be paid (but has not been paid yet) to taxing authorities in connection with the uncertain positions must be reflected on the utility's balance sheet as a tax liability (the FIN 48 amount). (Id., p. 11.) If, as expected, the uncertain amounts are repaid to the taxing authority, they must be repaid with applicable interest and penalties. (Id.)

Thus, the expectation is that the FIN 48 amounts will be repaid. With the FIN 48 amounts included in a rate base deduction as part of ADIT, as the ALJPO finds, IAWC's rate base is lower than it otherwise would be. If, as expected, the FIN 48 amounts are remitted to the taxing authorities, IAWC will no longer have the FIN 48 funds, but will still have the rate base deduction until the next rate case. Rather than addressing this *more likely* scenario, however, the ALJPO attempts to provide a mechanism purported to "protect" ratepayers from a *less likely* scenario. Put another way, the ALJPO has prematurely conferred to ratepayers the benefit of a finding by the taxing authority that the uncertain tax deductions should be allowed, even though such a finding has not yet been made and is the *less likely* outcome. Under the ALJPO's result, IAWC would be better off not taking the uncertain tax position at all, even though taking such a position benefits ratepayers.

The ALJPO appears to recognize the ratepayer benefit to taking uncertain tax positions: the ALJPO acknowledges that customers will "receive the benefit of the deferred tax credits, in the form of a rate base reduction," although the ALJPO is concerned that this will not happen "until the first rate case after tax returns are no longer subject to IRS review and adjustment." (ALJPO, p. 35.) Thus, although the ALJPO finds the benefit may not accrue until a subsequent case, it does not appear to dispute the existence of the benefit. In fact, the record confirms such a benefit. (See IAWC Init. Br., pp. 39-40.) Both Staff and the AG agree that taking uncertain tax positions can benefit ratepayers. As Staff witness Mr. Kahle testified, "[t]he Company should still have an incentive to make uncertain tax positions." (ICC Staff Ex. 9.0-C (Kahle Reb.), p. 13.) AG witness Mr. Smith also agrees that, if the utility is successful on its uncertain position, its ratepayers can benefit. (Tr. 705-06.) Thus, IAWC should be encouraged to take uncertain tax positions to obtain this ratepayer benefit. (IAWC Init. Br., pp. 40-42.) But the ALJPO's determination to adopt the AG's and Staff's (in part) position and include FIN 48 amounts in the ADIT balance, and so reduce rate base by those amounts, eliminates this incentive by placing the burden of the FIN 48 amounts solely on IAWC.

Adopting IAWC's position, by contrast, is the most reasonable and balanced approach available on the record. By excluding FIN 48 balances from ADIT, IAWC is not penalized for taking uncertain tax positions. And to the extent the "less likely" result does occur, and the taxing authority allows the uncertain positions, IAWC's ratepayers will benefit from that result. Thus, the potential for ratepayer benefit is still retained.

Finally, the record makes clear that there is a cost associated with the FIN 48 amounts. When, as expected, FIN 48 amounts are repaid, they must be repaid with interest and penalties, if applicable. (IAWC Ex. 13.00SR (Warren Sur.), p. 3.) Thus, unlike ADIT, FIN 48 liabilities cannot be considered a source of cost-free capital. (Id.; cf. ALJPO, p. 35 (ADIT represents an "interest free source of funds").) Staff recognizes that interest can accrue on the FIN 48 amounts. (ICC Staff Ex. 9.0-C, p. 13.) AG witness Mr. Smith also recognizes the possibility that interest and penalties can accrue. (Tr. 702; AG Ex. 4.0 C (Rev.) (Smith Reb.), p. 30.) And the FIN 48 pronouncement itself requires that interest and, if applicable, penalty amounts be recorded. (IAWC Cross Ex. 8, p. 4.) Thus, its is clear that, unlike ADIT, FIN 48 amounts do have a cost. As a result, the ALJPO's conclusion that "[t]he Commission agrees with AG and Staff that the FIN 48 amount represents a source of cost-free capital that should be reflected as a rate base deduction" (ALJPO, p. 35) is incorrect and not supported by the record. The result flowing from that incorrect conclusion, that the FIN 48 amounts should be included in ADIT and deducted from rate base, should be reversed and the exceptions language in Appendix A should be adopted.

F. Exception 6: ALJPO Section V.D, "Costs Related to Audit of Service Company Fees", Subsection 4, "Conclusion" (ALJPO, pp. 58-59.)

The ALJPO correctly recognizes that Illinois law mandates recovery of costs incurred by IAWC related to the management audit in Docket 10-0366. (ALJPO, pp. 58-59.) However, the ALJPO sets a cap on that cost recovery at \$784,200—the independent auditor's fee of \$392,100, plus the same amount as a cap on the incremental costs incurred by IAWC solely as a result of the audit. (Id., p. 59.) The ALJPO takes the position that incremental audit cost amounts above the equivalent of the auditor's fee are disproportionately high. But this approach lacks foundation in Illinois law and the record evidence. The ALJPO should be revised to permit full recovery of the prudent and reasonable incremental costs borne by IAWC to support and facilitate the management audit.

1. The ALJPO's Cap on Audit Cost Recovery Is Contrary to Illinois Law.

The ALJPO denies IAWC full recovery of its incremental audit costs, criticizing them as "disproportionate" to the auditor's fee (ALJPO, p. 58) and "disproportionate" to IAWC's (unrelated) rate case expense in this proceeding (id., p. 59). But whether the incremental audit costs are "proportionate" to the auditor's fee or another expense is not the standard for recovery. Section 8-102 of the Public Utilities Act is clear: "The *cost* of an independent audit shall be borne initially by the utility, but *shall be recovered* as an expense through normal ratemaking procedures." 220 ILCS 5/8-102 (emphasis added). The $722,000 of incremental costs are costs of the audit "borne by the utility" (IAWC)—for consultants, legal services and affiliate labor costs directly charged to IAWC. As such, they are recoverable. Section 8-102 does not limit the audit "cost" to the independent auditor's fee or to any proportion of that fee. (Id.) Moreover, neither the Docket 09-0319 Amendatory Order nor the Docket 10-0366 Initiating Order limits the audit "cost" to the auditor's fee or a relative proportion thereof. Amendatory Order, Docket 09-0319 (May 5, 2010), pp. 1-2; Initiating Order, Docket 10-0366 (June 10, 2010), pp. 1-2. Thus, the authority governing the subject management audit—Section 8-102 and the Dockets 09-0319 and 10-0366 orders—explicitly acknowledge retention of the independent auditor but do not limit audit cost recovery to that auditor's fee or relative to it. In fact, they do not place *any* cap on audit cost recovery. Rather, their plain language mandates IAWC *shall* recover the "cost" of the audit.

This makes sense. Practically speaking, it is the auditor, not the utility, which controls the scope of the audit. As the party responding to and defending the audit, the utility's costs necessarily may exceed the independent auditor's fee. For instance, greater time and, as a result, expense, often is expended in answering data requests and interview questions than in drafting them. In this case, IAWC produced over 11,000 pages of documents in response to over 400 data requests. (IAWC Ex. 4.00 (Grubb Dir.), p. 14.) The auditor conducted over 65 interviews, which required preparation as well as attendance by interviewees. Many of the interviews were conducted outside Illinois. (Id.) As such, it is unfair to judge a utility's costs in defending itself in an audit at the level of the independent auditor's fee or a portion thereof.

As the ALJPO also recognizes, consistent with the plain language of Section 8-102, Commission precedent deems the "cost" of a management audit to include not only the independent auditor's fee, but also the incremental costs incurred by the utility subjected to the audit. See, e.g., North Shore Gas Co., Order, Docket 91-0010, 1991 Ill. PUC LEXIS 636, *29 (Nov. 8, 1991) ("[T]he Commission has consistently allowed recovery of costs other than auditor fees . . . ."). But no prior Commission order has required that the incremental audit costs be "proportionate" to the independent auditor's fee. See Peoples Gas Light & Coke Co., Order, Docket 90-0007, 1990 Ill. PUC LEXIS 593, *52-54 (Nov. 9, 1990); Central Ill. Pub. Svc. Co., Order, Docket 90-0072, 1990 Ill. PUC LEXIS 625, *35-40 (Nov. 28, 1990); Central Ill. Light Co., Docket 90-0127, Order, 1991 Ill. PUC LEXIS 17, *36-44 (Jan. 16, 1991); Contel of Ill., Inc., Order, Docket 90-0128, 1991 Ill. PUC LEXIS 18, *78-81 (Jan. 16, 1991); North Shore Gas Co., Order, Docket 91-0010, 1991 Ill. PUC LEXIS 636, *27-29 (Nov. 8, 1991). To the contrary, the Commission has expressly found "[i]t is consistent with the purpose of Section 8-102 for the Commission to adopt an interpretation which allows utilities the *full recovery* of audit costs which are initially incurred by the utility." Peoples Gas Light & Coke Co., 1990 Ill. PUC LEXIS at *54 (emphasis added). The Commission's Staff agrees. (Staff Init. Br., p. 27 ("[I]t is appropriate to include as recoverable operating expenses the incremental costs that were solely incurred to support and facilitate the performance of the management audit.").)

Only the AG argues to the contrary. But, to the extent the ALJPO relies on the AG's argument that IAWC's incremental audit costs are somehow "disproportionate" to the independent auditor's fee—an argument the AG makes without a single citation to record evidence (see AG Reply Br., pp. 12-13, 19)—the Commission should be aware the AG's discussion misconstrues the relevant precedent. For instance, the AG asserts in Docket 90-0072, the Commission approved $6,400 in incremental costs for an audit otherwise costing $157,000. (AG Reply Br., pp. 12-13.) That is wrong. Docket 90-0072 was a gas rate increase proceeding filed by a combination gas and electric utility. Central Ill. Pub. Svc. Co., 1990 Ill. PUC LEXIS at *1-3. The $6,400 figure represented an amortized portion (one-fifth) of the incremental audit costs attributable to the utility's gas operations. Id. at *35-37. Thus, the total incremental costs attributable to those operations were five times that amount, or $32,000. Id. There is no indication in the order of the total cost of the management audit for the combined utility, the total cost of the independent auditor, or the total incremental costs incurred by the combined utility. Id. at *35-40. Nevertheless, the AG takes liberty in (mis)calculating a ratio of incremental audit costs to the auditor's fee in that docket. Regardless, the order permitted *full recovery* of the gas utility's incremental audit costs. That cannot be disputed.

The AG next asserts Docket 90-0127 concerned $26,294 in incremental costs. (AG Reply Br., p. 13.) That also is wrong. The incremental costs in that docket were $52,937, $26,294 of which was at issue. Central Ill. Light Co., 1991 Ill. PUC LEXIS at *37-38. As such, again, the AG miscalculates its "proportion." IAWC also notes the auditor's fee in that 22-year-old case was $772,021. Id. at *36-37. (It is unclear what that charge encompassed.) Again, the Commission in that docket permitted *full recovery* of the incremental audit costs. Id. at *39-40 ("In this instant case, CILCO's contentions that the additional costs in question were prudently incurred as a necessary part of the audit process, and are not otherwise recovered through rates, are supported by evidence of record. The Commission concludes that a ratable portion of these prudent and necessary one-time audit costs, like those assessed by the independent auditor, should be recovered . . . .")

The AG next references Docket 90-0128. It contends IAWC's legal-related incremental audit costs are "grossly disproportionate" to the $6,000 legal costs at issue there. (AG Reply Br., p. 13.) But there is no indication in that over 20-year old order of the total cost of the management audit or the basis for the admittedly "modest" legal costs incurred. Contel of Ill., Inc., 1991 Ill. PUC LEXIS at *80. Regardless, again, the Commission in that case permitted *full recovery* of that incremental audit cost.

Finally, and most notably, the AG attempts to distinguish Docket 91-0010 based on the Commission's approval in that case of the utility's audit implementation costs. (AG Reply Br., pp. 13-14.) North Shore Gas Co., 1991 Ill. PUC LEXIS at *28-29. In so doing, however, the AG ignores the Commission there expressly concluded: "The Commission is of the opinion that the Public Utilities Act does not explicitly or implicitly limit recovery of audit costs to fees paid to the management auditor. Consistent with this interpretation, the Commission has consistently allowed recovery of costs other than auditor fees, *including* audit implementation costs." North Shore Gas Co., 1991 Ill. PUC LEXIS at *28-29 (emphasis added). Thus, the Commission recognized implementation costs are merely a subset of the incremental audit costs it "consistently" allows. The AG seeks to distinguish this case because there, like here, the auditor's fee represented approximately one-third of the total costs of the audit. Id. at *27. Nevertheless, the Commission allowed *full* recovery of those costs. Id. at *29.

In sum, the ALJPO's cap on audit cost recovery is contrary to Illinois law.

2. The ALJPO's Cap on Audit Cost Recovery Is Contrary to the Record.

The ALJPO also finds "IAWC has not justified the reasonableness of the requested amount of incremental costs of $722,000." (ALJPO, p. 59.) Respectfully, this overlooks both the record evidence and the reality of the audit. The level of IAWC's incremental audit costs supported by that evidence cannot be simply disregarded in favor of an arbitrary lower amount. See Peoples Gas Light & Coke Co. v. Slattery, 373 Ill. 31, 61-62 (1939) (the Commission may not simply disregard the level of a utility operating expense as shown by evidence in a rate proceeding in favor of an arbitrary lower amount).

The record evidence *does* justify the reasonableness of IAWC's incremental audit costs. IAWC explained at length the need for the services of outside counsel to represent it before the Commission in Docket 10-0366 and for the services of an audit consultant to assist IAWC in responding to the audit. (See IAWC Exs. 4.00, pp. 14-15; 7.00SR (Bernsen Sur.), pp. 13-14; AG Cross Ex. 8, p. 2.) The evidence shows that consultant was needed to facilitate the timely completion of the audit process in the condensed timeframe required by the Docket 10-0366 Initiating Order; monitor and track the audit process; provide support to IAWC personnel in preparing for the audit, responding to the auditor's data requests, and responding to the audit report; and provide other support as required. That evidence also demonstrates the necessity of IAWC's internal incremental audit costs, such as charges for Service Company personnel to prepare for and participate in interviews and respond to data requests related to the audit, the cost to provide workspace for the auditor and data room management, and other administrative charges related to providing the auditor the information it requested throughout the course of the audit and in reviewing and responding to the final audit report. (Id.)

No witness rebutted that evidence or otherwise testified the total audit cost or any component of IAWC's incremental audit costs was unnecessary or unreasonable. (See generally

AG Exs. 2.0 C (Rev.) (Smith Dir.), pp. 77-78; 4.0 C (Rev.) (Smith Reb.), pp. 35-36.) In fact, Staff's witness explicitly agreed the costs should be recovered. (ICC Staff Ex. 11.0 (Ostrander Reb.), p. 11; IAWC Cross Ex. 4 (IAWC-ICC 8.02).) IAWC's unrebutted evidence should be given effect. See Thigpen v. Ret. Bd. of Fireman's Annuity & Benefit Fund of Chicago, 317 Ill. App. 3d 1010, 1021 (1st Dist. 2000) ("[T]he agency as fact finder cannot simply disregard the testimony of an unimpeached witness where the testimony is uncontradicted and is not inherently improbable.").

The record evidence also reflects the reality of the management audit. In the course of that audit, as stated, the auditor conducted over 65 interviews of IAWC and Service Company personnel and issued over 400 data requests, in response to which IAWC provided nearly 11,000 pages of information. (IAWC Ex. 4.00, p. 14.) The Docket 10-0366 Initiating Order also permitted IAWC to suggest technical corrections to the audit report and required it to prepare and file a response to the same. Initiating Order, Docket 10-0366, p. 5. Indeed, the ALJPO itself acknowledges the audit process was both "lengthy and detailed." (ALJPO, p. 177.) Thus, the finding that IAWC's incremental audit costs are unreasonable or unjustified is contrary to the record evidence and the reality of the Docket 10-0366 management audit.

The ALJPO also states the incremental audit costs were "well above the upper end of the $400,000 to $600,000 estimate prepared by IAWC." (ALJPO, p. 58.) But, as IAWC explained in briefing, at the time of those estimates, Staff had only initiated a Request for Proposals process and an independent auditor had not yet been selected. (IAWC Init. Br., p. 42 (citing AG Cross Ex. 8, p. 1).) Thus, not even the auditor's cost was known at that time. Accordingly, the cost estimates "represent[ed] IAWC's best current estimate of the costs necessary to support the audit process and, if necessary, *will be supplemented with updated estimates or actual costs*." (Id.

(quoting AG Cross Ex. 8, p. 3) (emphasis added).) When IAWC filed its rate case on October 27, 2011—after the auditor had been selected and begun the audit process—the Company did just that: it updated its estimates. (IAWC Ex. 4.00, pp. 14-15.) Not only does the ALJPO appear to overlook those revised estimates, but also, its determination to cap audit costs at the auditor's fee amount actually puts the allowed incremental amount *below* the range of IAWC's unrevised estimates.

In sum, the ALJPO should be revised and IAWC should be permitted full recovery of its incremental audit costs, consistent with Illinois authority and the record here. The Commission should adopt IAWC's exceptions language included in Appendix A.

G. Exception 7: ALJPO Section IX.F, "Other Issues" (ALJPO, pp. 135-36.)

The ALJPO correctly rejects IIWC/FEA's recommendation that it start taking service under a Competitive Service tariff, aptly noting Scott Air Force Base ("AFB") is free to apply for the Competitive Service tariff if it chooses. (ALJPO, p. 136.) However, on rebuttal, IIWC/FEA witness Mr. Collins testified Scott AFB planned to apply to the Company to take service under the Metered Large User Water Service tariff ("Large User tariff") rate because it believes service under that tariff rate will address the concerns IIWC/FEA raised in this regard. (IIWC/FEA Ex. 4.0 (Collins Reb.), p. 7.) In its surrebuttal testimony, IAWC acknowledged that intent, and, in anticipation of Scott AFB's switch to the Large User tariff rate, the Company adjusted its test year present rate revenues downward by $111,808.00. (IAWC Exs. 5.00SR (Rev.) (Kerckhove Sur.), p. 22; 5.09SR, p. 46 ("Scott Air Force Base Revenues for the Test Year Ending September 30, 2013").) The ALJPO determines IAWC's test year revenues using the Company's rebuttal position as the starting point. (See, e.g., ALJPO, Appx. A.) Because the adjustment was not made by IAWC until its surrebuttal filing, it is not reflected in the ALJPO. Accordingly, a revenue reduction of $111,808.00 is necessary to reflect Scott AFB's expected move (prior to the test year) to the Large User tariff rate, as stated by IIWC/FEA and anticipated by the Company. (IAWC Ex. 5.09SR, p. 46.) The ALJPO should be revised accordingly; the Commission should adopt IAWC's exceptions language included in Appendix A.

H. Exception 8: ALJPO Section IX.D, "Consolidated of Volumetric Charges", Subsection 2, "IAWC's Position" (ALJPO, p. 134) and Subsection 3, "Conclusion" (ALJPO, pp. 134-35.)

The ALJPO correctly rejects IIWC/FEA's proposal to consolidate the volumetric charges for Air Products' two meters because the record does not substantiate IIWC/FEA's claim or support finding that IAWC somehow is failing to comply with its tariff (it is not) or that the tariff should be modified in this regard (it should not). (ALJPO, p. 135.) However, IAWC proposes certain clarifying changes to the ALJPO to make its position clear. The question is not whether Air Products has two meters or whether those meters *are served* by the same distribution main; rather, the issue is whether the meters *serve* a common distribution system—in other words, that the system behind Air Products' meters is a common system. (IAWC Ex. 5.00SR (Rev.) (Kerckhove Sur.), p. 22.) As explained by IAWC witness Mr. Kerckhove, IAWC's rules and regulations state, "When more than one meter setting is installed on a Customer's Premises, each meter setting shall be treated separately (i.e., as if it belonged to a separate Customer). The registrations of such meters will not be combined *unless such meters measure water being received by a common distribution system*." (IAWC Ex. 5.00R (2d Rev.) (Kerckhove Reb.), pp. 27-28 (citing ILL.C.C. No. 23, Original Sheet No. 10) (emphasis added).) IIWC/FEA provided no evidence that its meters measure water being received by a common distribution system in accordance with IAWC's tariff provision. (See IIWC/FEA Ex. 4.0 (Collins Reb.), p. 9.) As such, it cannot be confirmed that the tariff applies. The Commission should therefore adopt IAWC's exceptions language included in Appendix A.

III. ORAL ARGUMENT REQUEST

Pursuant to Section 9-201(c) of the Public Utilities Act, 220 ILCS 5/9-201(c), and Rule 200.850(a) of the Commission's Rules of Practice, 83 Ill. Adm. Code § 200.850(a), IAWC respectfully requests that oral argument be held in this proceeding, including but not limited to the subject of the authorized rate of return.

IV. CONCLUSION

For the reasons set forth above, IAWC requests that the Commission adopt the Exceptions discussed above and set forth in the respective sections of Appendix A hereto.

Dated: August 13, 2012

Respectfully submitted,

Illinois-American Water Company

By:
/s/ Anne M. Zehr

One of their attorneys

Albert D. Sturtevant
Anne M. Zehr
Rebecca L. Segal
WHITT STURTEVANT LLP
180 N. LaSalle Street, Suite 2001
Chicago, Illinois 60601
Phone: 312-251-3017
sturtevant@whitt-sturtevant.com
zehr@whitt-sturtevant.com
segal@whitt-sturtevant.com

Mark A. Whitt
WHITT STURTEVANT LLP
PNC Plaza, Suite 2020
155 East Broad Street
Columbus, Ohio 43215
Phone: 614-224-3911
whitt@whitt-sturtevant.com

John J. Reichart
Kenneth C. Jones
Illinois-American Water Company
727 Craig Road
St. Louis, Missouri 63141
314-996-2287
John.Reichart@amwater.com
Kenneth.Jones@amwater.com

CERTIFICATE OF SERVICE

I, Anne M. Zehr, certify that on August 13, 2012, I caused a copy of the foregoing *Brief on Exceptions of Illinois-American Water Company* to be served by electronic mail to the individuals on the Commission's Service List for Docket No. 11-0767.

/s/ Anne M. Zehr
Attorney for Illinois-American Water Company